

No. 10,932

IN THE
United States Circuit Court of Appeals
For the Ninth Circuit

UNITED STATES OF AMERICA,

Appellant,

VS.

PAUL W. SAMPSELL, Trustee in Bankruptcy
of the Estate of El Camino Refining
Company, STATE OF CALIFORNIA and UNI-
VERSAL CONSOLIDATED OIL COMPANY,

Appellees.

BRIEF FOR APPELLEE STATE OF CALIFORNIA.

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BRIEF FOR APPELLEE STATE OF CALIFORNIA.

QUESTION PRESENTED.

This brief deals only with the first question discussed in the government's brief. Strictly speaking, that question is: "Is a lien of the United States for gasoline taxes entitled to priority in bankruptcy over an earlier, but inchoate, lien for California Franchise Taxes?"

STATUTES INVOLVED.

The statutes involved are printed in the Appendix.

STATEMENT.

The State of California does not controvert the government's statement of the case, but for convenience we are setting forth the essential facts at this point.

El Camino Refining Company filed a petition for reorganization under Chapter X of the Bankruptcy Act on May 12, 1942. It was adjudicated bankrupt on March 27, 1943, and its assets have been sold free and clear of liens.

There are three lien claims which exceed the value of the assets of the estate.

(1) The claim of the State of California for franchise taxes of the taxable years 1939 and 1940 amounting to \$3634.22 together with interest at the rate of 6% per annum from January 15, 1944, until paid. This lien attached in part on the first day of January, 1939 and in part on January 1, 1940. (Bank and Corporation Franchise Tax Act, Section 26.) It was not determined as to amount until August 13, 1942.

(2) The claim of the Universal Consolidated Oil Company allowed in the sum of \$11,234.78, together with interest, based upon a mortgage executed on January 10, 1941 and recorded May 3, 1941.

(3) The claim of the United States for gasoline taxes in a sum in excess of \$20,000. The lien for these taxes attached on several dates between January 6, 1942 and June 18, 1942.

The District Court concluded that the liens were entitled to priority in the order in which they attached

and since the assets were insufficient to pay both the State's claim and the mortgagee's claim in full did not pass upon the legality of the government's claim.

SUMMARY OF THE ARGUMENT.

The question involved is one of statutory construction. Neither the Bankruptcy Act nor the Internal Revenue Code grants the United States priority over the states. The lien of the State of California is valid and must be recognized in bankruptcy. In this case it is first in time and it is therefore first in right.

The authorities cited by the government are of no assistance in interpreting Sections 3670-72 of the Internal Revenue Code. Section 3466 of the Revised Statutes differs materially from the statutes involved here and cases interpreting it are not in point.

ARGUMENT.

A. CONGRESS HAS NOT MADE THE LIEN OF THE UNITED STATES SUPERIOR TO INCHOATE LIENS.

The State is well aware of the fact that the Constitution "and the laws of the United States which shall be made in pursuance thereof" are the supreme law of the land. Congress unquestionably could provide that a lien of the United States for taxes or other debts should be paramount over all other liens, including state taxes.

But Congress has not done so. It has, on the contrary, provided that the liens of the United States shall be subordinate to certain types of liens, including, we believe, prior liens for state taxes whether such liens are perfected or inchoate.

The government's claim of priority does not rest upon the Bankruptcy Act, for that act merely provides that valid liens (including liens for State and Federal taxes) shall be recognized by the Bankruptcy Court. The act gives no lien priority over another. It recognizes so-called inchoate liens as well as perfected liens for it permits the perfection of liens for taxes after bankruptcy. As the government now concedes, this point was conclusively determined against it in the case entitled *In re Knox-Powell-Stockton* (9 Cir.), 100 Fed. (2d) 979. That case involved a number of tax liens arising under California law, all of which, including a lien for franchise taxes, were inchoate. This Court held that all of the claims were valid liens and were entitled to priority over unsecured claims, including an unsecured claim of the United States for taxes.

The government's lien is created by Sections 3670-3672 of the Internal Revenue Code (Revised Statutes Sec. 3186; U.S.C. 3670-3672) and its claim for priority also rests upon those sections. The three sections in substance provide that if a tax is not paid it shall be a lien; that the lien shall arise at the time the assessment list is received by the collector; and that the lien "shall not be valid as against any mortgagee,

pledgee, purchaser, or judgment creditor" until notice thereof has been filed by the collector with certain local officials or with the clerk of the District Court.

The history of the three sections is set forth in *United States v. Beaver Run Coal Co.* (5 Cir.), 99 Fed. (2d) 610, 612:

"Ever since the Act of July 13, 1866 (14 Stat. 107) the United States has been given a lien for unpaid taxes. Section 3186, Revised Statutes, 26 U.S.C.A., Secs. 1560, 1561, 1562. As amended in 1879, and prior thereto, Section 3186 contained no provisions for the recording or filing of the lien, but merely provided as follows: 'If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount shall be a lien in favor of the United States from the time when the assessment list was received by the collector, except when otherwise provided, until paid, with the interest, penalties, and costs that may accrue in addition thereto upon all property and rights to property belonging to such person.' 20 Stat. 331, 26 U.S.C.A., Sec. 1560 note.

"On May 1, 1893, the United States Supreme Court, in the case of *United States v. Snyder*, 149 U.S. 210, 13 S. Ct. 846, 37 L. Ed. 705, held that the lien created by the above section was not subject to the recording laws of the states, and that it was enforceable even against a subsequent bona fide purchaser for value without notice. This decision cast a cloud of uncertainty upon titles to land throughout the United States and, before long, under the leadership of the American Bar Association, agitation for remedial legislation began. By the Act of March 4, 1913, Congress

amended section 3186 by adding thereto a provision 'that such lien shall not be valid as against any mortgagee, purchaser, or judgment creditor until' certain recording and filing requirements, thereafter set forth, had been fulfilled. 37 Stat. 1016, 26 U.S.C.A., Sec. 1560 note.

"This section, with minor amendments, has ever since been retained on the statute books. The latest amendment, made by the Act of May 29, 1928, 45 Stat. 875, 26 U.S.C.A., Sec. 1560 et seq., sets forth the provisions applicable to this case
* * *".

The statute was again amended in 1936 (49 Stat. 1921) and is set forth in the appendix in its present form. The changes then made are not material here.

It will be seen that the language of Section 3672 is subject to the construction that the tax lien upon recording would not only become valid as against mortgagees and judgment creditors, but would also become paramount (i.e., superior to earlier liens). However, the language has been interpreted at all times to mean that the lien of the United States is inferior to all mortgage and judgment liens acquired prior to the date of recording or filing of the notice.

Trust Company of Texas v. United States, 3 Fed. Supp. 683;

Fox v. Queens County Sales Co., Inc. (D. C.), 52 Fed. (2d) 794;

Sherwood v. U. S. (D. C.), 5 Fed. (2d) 991;

Integrity Trust Co. v. United States, 3 Fed. Supp. 577;

Minnesota Mutual Life Insurance Co. v. U. S. (D. C.), 47 Fed. (2d) 942.

These decisions are consistent with the general rule that a lien is not paramount unless the statute compels that conclusion. (Cf. *Home Owners Loan Corp. v. Hansen*, 38 C. A. (2d) 478, 102 Pac. (2d) 417.)

It will be noted that Section 3671 also refers to the time when the lien arises. This is the time at which the government's lien takes effect. It has been held that the government's lien is subject to all liens upon the property in existence at the time the government's lien arose. Thus in *United States v. City of Greenville* (5 Cir.), 118 Fed. (2d) 963, 966, the Court said:

“Whether the lien provided by the statute is entitled to priority over antecedent liens for taxes duly perfected by states or municipalities is a question which is not before us and which we need not decide. It would seem, however, that the lien was intended to attach to the property of the taxpayer subject to existing encumbrances; and this is borne out by the provision that it shall not be valid as against mortgagees, purchasers or judgment creditors until notice thereof is duly filed as provided by the act. This interpretation places liens of the federal government and liens of the states on an equal basis for the application of the principle first in time, first in right (*Rankin v. Scott*, 12 Wheat. 177, 179, 6 L. Ed. 592), which is the principle ordinarily applied with respect to priority of liens, and the one applied between a tax lien and other liens where the tax lien is not made paramount by statute. 61 C. J. p. 934.”

If the 1913 amendment adding Section 3672 had been intended only to protect mortgagee, judgment

creditors and bona fide purchasers (as the government contends) Section 3671 would have been unnecessary. Section 3671 was included to protect the holders of statutory and equitable liens acquiring their liens prior to receipt of the assessment list by the collector. The government acquires no interest in the property of the taxpayer until that event occurs and that interest is subject to all existing encumbrances.

Certainly there is nothing in Sections 3670 to 3672 to support the government's position that perfected liens (other than the liens of mortgagees and judgment creditors) are protected by Section 3671, but that so-called inchoate liens are not.

**B. THE AUTHORITIES CITED BY THE GOVERNMENT
ARE NOT IN POINT.**

1. United States v. Texas.

The government places its principal reliance upon cases such as *United States v. Texas*, 314 U. S. 480, interpreting Section 3466 of the Revised Statutes. (31 USC 1940 Ed. Sec. 191.) That section provides in substance that when a debtor is insolvent or has committed an act of bankruptcy, the United States shall be first paid. This statute is controlling in equity receiverships and is also controlling where the debtor executes an assignment for the benefit of his creditors. It is not controlling in bankruptcy cases. In the case entitled *In re Knox-Powell-Stockton*, 100 Fed. (2d) 979, this Court said (p. 982):

“To support its position that section 67d preserves only ‘perfected’ liens, appellant cites: *Spokane County v. United States*, 279 U. S. 80, 49 S. Ct. 321, 73 L. Ed. 621; *New York v. Maclay*, 288 U. S. 290, 53 S. Ct. 323, 77 L. Ed. 754, and *Gerson, Beesley & Hampton v. Shubert Theatre Corp.*, D. C. S. D. N. Y. 1934, 7 F. Supp. 399. All of these cases arose under section 3466 of the Revised Statutes, 31 U.S.C.A. Sec. 191, which grants priority to the United States over all other creditors when the debtor is insolvent. The cited cases establish that under this section an inchoate lien will not defeat the priority established by said section. But this being a bankruptcy proceeding, the provisions with respect to priority under section 3466 of the Revised Statutes do not apply here. *Guarantee Title & Trust Co. v. Title Guaranty & Surety Co.*, supra; *Davis v. Pringle*, supra; *Claude D. Reese, Inc. v. United States*, 5 Cir. 1935, 75 F. 2d 9. And in construing section 67d of the Bankruptcy Act our inquiry as to what constitutes a lien thereunder is not embarrassed by the auxiliary consideration as to whether the lien of a tax not presently enforceable is sufficient to avail against a statutory preference which is to be liberally construed in favor of the United States. *Spokane County v. United States*, 279 U. S. 80, 49 S. Ct. 321, 73 L. Ed. 621, quoting *Price v. United States*, 269 U. S. 492, 499, 46 S. Ct. 180, 70 L. Ed. 373.”

Section 3466 of the Revised Statutes contains no exceptions; it simply declares that upon insolvency the United States shall be first paid.

In *United States v. Texas*, 314 U. S. 480, the Court not only held that the priority of the United States cannot be defeated by general and inchoate liens, but also questioned the soundness of early decisions holding that the mortgagee is entitled to priority over the United States. It was said that in several early cases "this Court read an exception into the section in the case of previously executed mortgages * * * this doctrine seems to have been based on the theory that mortgaged property passes to the mortgagee and is no longer a part of the estate of the mortgagor."

In *Spokane County v. United States*, 279 U. S. 80, the Court held that the lien of the county for property taxes was not specific and was inchoate and was therefore insufficient to take the property out of the estate of taxpayer. This, in substance, is the reason why the Court has drawn a distinction between perfected liens and inchoate liens in cases arising under Section 3466. It was thought that a perfected lien might be sufficient to take the property out of the estate of the taxpayer so as to avoid the effect of Section 3466, but it was held that a general and inchoate lien was insufficient for this purpose.

2. *Michigan v. United States.*

The government also relies upon the case of *Michigan v. United States*, 317 U. S. 338. In that case the government's lien arose under Section 315a of the Revenue Act of 1926. (26 USC 253.) A full discussion of that statute will be found in the companion case of *Detroit Bank v. United States*, 317 U. S. 329.

Section 315(a) of the Revenue Act gives the United States a lien for estate taxes. The lien attaches to the gross estate of the decedent on the date of his death. The only exception contained in this statute is a provision protecting bona fide purchasers of property transferred *inter vivos* by the taxpayer.

In the *Detroit Bank* case a widow executed a mortgage after the death of her husband and prior to the assessment of additional estate taxes against his estate by the United States. It was held that the inchoate lien of the government was entitled to priority over the mortgage. The Court rejected the argument that Section 3672 of the Internal Revenue Code required the filing of notice of estate tax liens to protect mortgagees. Indeed, the Court's decision is based upon the fact that the lien for estate taxes was inchoate and entirely different in character from the lien created by Sections 3670 to 3672.

In *Michigan v. United States*, the Court simply applied the same rule to property taxes which became a lien after the government's inchoate lien attached. The Court then stated that it was unnecessary to pass upon the question of whether or not the government's inchoate lien would take precedence over earlier perfected liens for taxes and cited in that connection cases arising under Section 3466 of the Revised Statutes. The Court plainly indicated that the answer to this question was to be found by ascertaining the intent of Congress, not by applying any rule of thumb that state liens are always inferior to liens of the United States.

3. **United States v. Reese.**

Finally, the government relies upon *United States v. Reese* (7 Cir.), 131 Fed. (2d) 466. In that case the government commenced an action to foreclose a lien for income taxes which had attached on December 7, 1931. The taxpayer was adjudicated bankrupt on July 3, 1936.

An examination of the opinion discloses that the Court did not discuss the language or effect of Sections 3670-3672 but that it assumed without discussion that cases decided under Section 3466 of the Revised Statutes were controlling. With but two exceptions, none of the cases cited by the Court arose in bankruptcy proceedings and none of the cases cited dealt with the priority liens of the United States under Sections 3670-3672 as amended in 1913.

One of the cases cited by the Court was *United States v. Fisher*, 2 Cranch 358, which was decided in 1805, when the Bankruptcy Act provided in part "that nothing contained in this law shall in any manner affect the rights of preference to prior satisfaction of debts due to the United States, and secured or provided by any law heretofore passed, nor shall be construed to lessen or impair any right to, or security for, money due to the United States, or to any of them".

The Court also cited *United States v. National Surety Company*, 254 U. S. 73. This was a bankruptcy case, but it did not deal with the matter of the priority of liens of the United States.

The United States Supreme Court has twice held that Section 3466 of the Revised Statutes does not apply in bankruptcy proceedings.

Guarantee Title & Trust Co. v. Title Guaranty & Surety Co., 224 U. S. 152;

Davis v. Pringle, 268 U. S. 315.

As previously pointed out, this Court reached the same conclusion in the case entitled *In re Knox-Powell-Stockton Co.*, 100 Fed. (2d) 979.

Under these circumstances it is submitted that the *Reese* case is not controlling. It not only fails to consider the applicable provisions of the governing statute but it relies upon authorities which the Courts have been repeatedly held to be inapplicable in bankruptcy.

The government concedes that a tax lien perfected before its lien arises is entitled to priority. It has made the same concession in other cases. (See *In re Caswell Construction Co.* (D.C.), 13 Fed. (2d) 667; *United States v. City of Greenville* (5 Cir.), 118 Fed. (2d) 963.) The government does not tell us what it finds in Sections 3670-71-72 of the Internal Revenue Code which gives it priority over inchoate liens which antedate its own liens. We are aware of but one case involving the question of relative priority between a government lien arising under Section 3670 of the Internal Revenue Code and an inchoate lien. In that case (*In re Van Winkle*, 49 Fed. Supp. 711), the Court held that the equitable lien of a surety could be related back to defeat the government's lien. The government did not appeal.

CONCLUSION.

The United States Supreme Court has repeatedly recognized the validity and propriety of inchoate liens. (See *Detroit Bank v. United States*, supra; *United States v. Alabama*, 313 U. S. 274.) It is submitted that there is nothing in the Bankruptcy Act or in any other act of Congress which grants liens of the United States priority over earlier inchoate liens.

Dated, San Francisco, California,

April 27, 1945.

Respectfully submitted,

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(Appendix Follows.)

Appendix.



Appendix

Internal Revenue Code, [as amended by Sec. 521 (a) (20) of the Revenue Act of 1941, c. 412, 55 Stat. 687]:

SEC. 3412. TAX ON GASOLINE.

(a) There shall be imposed on gasoline sold by the producer or importer thereof, or by any producer of gasoline, a tax of $1\frac{1}{2}$ cents a gallon, except that under regulations prescribed by the Commissioner with the approval of the Secretary the tax shall not apply in the case of sales to a producer of gasoline.

* * * * *

(26 U. S. C. 1940 ed., Sec. 3412.)

SEC. 3670. PROPERTY SUBJECT TO LIEN.

If any person liable to pay any tax neglects or refuses to pay the same after demand, the amount (including any interest, penalty, additional amount, or addition to such tax, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

(26 U. S. C. 1940 ed., Sec. 3670.)

SEC. 3671. PERIOD OF LIEN.

Unless another date is specifically fixed by law, the lien shall arise at the time the assessment list was received by the collector and shall continue until the

liability for such amount is satisfied or becomes unenforceable by reason of lapse of time.

(26 U. S. C. 1940 ed., Sec. 3671.)

SEC. 3672. [as amended by Sec. 401 of the Revenue Act of 1939, c. 247, 53 Stat. 862]. VALIDITY AGAINST MORTGAGEES, PLEDGEEES, PURCHASERS, AND JUDGMENT CREDITORS.

(a) *Invalidity of Lien Without Notice.*—Such lien shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed by the collector—

* * * * *

(26 U. S. C. 1940 ed., Sec. 3672.)

Deering, California General Laws (1939 Supp.):
Act 8488. Bank and Corporation Franchise Tax Act:

SEC. 29. *Lien of tax: Inception and duration: Release of lien: Prerequisites to dissolution of taxpayer.*

(a) The taxes imposed by this act shall constitute a lien upon the real property of the taxpayer, which lien shall have the same force, effect and priority as a judgment lien and shall attach on the first day of the "taxable year," * * *.

* * * * *

Bankruptcy Act of 1898, c. 541, 30 Stat. 544, as amended by the Act of June 22, 1938, c. 575, 52 Stat. 840:

SEC. 64. *Debts Which Have Priority.* a. The debts to have priority, in advance of the payment of divi-

dends to creditors, and to be paid in full out of bankrupt estates, and the order of payment, shall be * * *

(4) taxes legally due and owing by the bankrupt to the United States or any State or any subdivision thereof:

* * *

* * * * *

(11 U. S. C. 1940 ed., Sec. 104.)

SEC. 67. *Liens and Fraudulent Transfers.*

* * * * *

b. The provisions of section 60 of this act to the contrary notwithstanding, statutory liens in favor of employees, contractors, mechanics, landlords, or other classes of persons, and statutory liens for taxes and debts owing to the United States or any State or subdivision thereof, created or recognized by the laws of the United States or of any State, may be valid against the trustee, even though arising or perfected while the debtor is insolvent and within four months prior to the filing of the petition in bankruptcy or of the original petition under chapter X, XI, XII, or XIII of this Act, by or against him. Where by such laws such liens are required to be perfected and arise but are not perfected before bankruptcy, they may nevertheless be valid, if perfected within the time permitted by and in accordance with the requirements of such laws, except that if such laws require the liens to be perfected by the seizure of property, they shall instead be perfected by filing notice thereof with the court.

* * * * *

(11 U. S. C. 1940 ed., Sec. 107.)

